I Introduction

1. This document presents options for a future strategic niche and new business model for the United Nations Capital Development Fund (UNCDF), in response to decision 2004/37 of the Executive Board taken at the September 2004 session. These options were developed in close consultations with donors, programme countries – especially least developed countries (LDCs) – and UNCDF.

2. In its decision 2004/37, the Executive Board requested the UNDP Administrator to elaborate five options to be presented at the first regular session in January 2005. These are:

(a) The option of an independent UNCDF focused on microfinance (presented as option 1 in DP/2004/46);

(b) As a corollary to the above option, to safeguard and build on UNCDF results in local development, a centre for local development (CLD), operating primarily in LDCs and maintaining a capital investment mandate separate from that of UNCDF, would be set up as a distinct unit within UNDP;

(c) The option of maintaining an independent UNCDF, focusing on practice areas in accordance with its current mandate, and, in this connection, to elaborate on the possibility for UNDP to strengthen its assistance to UNCDF in its advocacy efforts to mobilize the necessary resources;

(d) The option of integrating UNCDF activities and personnel dealing with microfinance into UNDP; and

(e) The option of an independent UNCDF focused on private sector development (presented as option 2 in DP/2004/46).

3. After consultation with Executive Board members and private sector representatives, UNDP management decided to dissociate the elaboration of option (e) from the deliberations on the future of UNCDF and to pursue it independently. For the remaining four options, the Administrator established four working groups with representatives from UNCDF and UNDP to develop and elaborate each option.

4. This document presents the description and technical analysis of those four options, detailing the relevant situation analyses and their implications for programming, funding and management arrangements, as well as an assessment of opportunities, risks involved, and key factors for the success of each. In this regard, the document presents a brief background on the programmatic and financial constraints currently facing UNCDF, reiterates the established framework for developing the strategic options, and outlines the options for the potential positioning of a revitalized UNCDF.

II Background

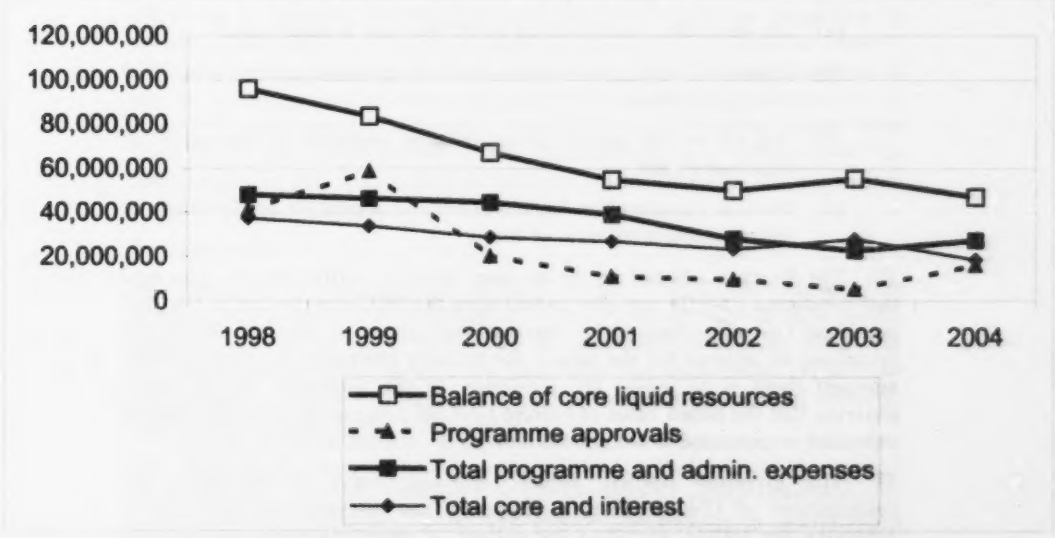
5. The Independent Impact Assessment (IIA)[1], conducted at the request of the Executive Board in 2003, confirmed that UNCDF has contributed, in many

[1] See document DP/2004/18

cases, through both its microfinance and local governance programmes, to significant results in poverty reduction, policy impact, and replication of its projects by other donors. The IIA also confirmed that UNCDF has effectively followed up on the recommendations of the 1999 external evaluation. Despite the positive findings on UNCDF development effectiveness and performance, the IIA questioned the existing business model of UNCDF, which was based on the key assumption that good results and an efficient, effective organization would lead to continued donor support and sustained core funding. This assumption is judged to be flawed since, despite good results, core contributions have dwindled. This has been only partly offset by increases in non-core resource mobilization, which are not predictable and cannot be used to cover the core administrative budget of the organization.

6. As Figure 1 demonstrates, the trend in the UNCDF financial situation for core resources between 1998 and 2004 has been downward, and programme approvals and expenditures have been reduced significantly to ensure the financial integrity of the Fund. The figure shows clearly the dramatic drop in core resources and the level of programme approvals in the period under review. The slight improvement reached in 2003 was not sustained, and in 2004 contributions fell to an all time low of $19 million, requiring further downward adjustment of programme expenditures and approvals for following years.

Figure 1. UNCDF financial situation with respect to core resources, 1998-2004 (in dollars)



7. The IIA report made several recommendations of which a key one, recommendation 2, called for the analysis, review and development of a new business model and appropriate corporate governance arrangements to support it. This led directly to Executive Board decision 2004/13, which called for the review exercise that resulted in the presentation of two possible options to the Executive Board at the September 2004 session (DP/2004/46). In reviewing

these two options, the Board, in its decision 2004/37, requested additional work to be done to elaborate the two options, as well as to explore and develop other options (mentioned in paragraph 2 above).

III. The framework for developing and reviewing the strategic options for UNCDF

8. At the September 2004 session of the Executive Board, four key 'guiding principles' that constitute the necessary preconditions to be met in identifying and vetting the strategic options for the future UNCDF niche and business model were proposed. The guiding principles include:

(a) The original legislative mandate given to UNCDF by the General Assembly in 1966;

(b) The vision and goals of the Millennium Development Goals (MDGs);

(c) The primacy and centrality of country priorities and needs; and

(d) The goals and objectives of the United Nations reform process of the Secretary General.

9. In addition to the above principles, four additional criteria were identified, each establishing desirable benchmarks for a future UNCDF niche and business model. In brief, the proposed options should:

(a) Define a clear, well-focused niche that easy to understand;

(b) Promise an adequate, reliable, and self-sustainable funding base for the organization;

(c) Aspire to set global standards and establish a reputation of excellence; and

(d) Provide opportunities for UNCDF to be a catalyst and leverage its partnerships in its areas of focus.

10. The Executive Board, in its decision 2004/13, reaffirmed the clear role that it believes UNCDF can play in achieving the MDGs in the LDCs. UNCDF possesses key advantages in the international efforts to meet the MDGs. In reviewing its options for the future, the primary challenge in selecting from amongst them is to assess the feasibility of the proposed options while ensuring that the added value of current UNCDF programmes and activities is enhanced or expanded to better contribute to the attainment of the MDGs.

11. The proposed options explore different ways to safeguard the contributions of UNCDF local development and microfinance activities to achieving the MDGs, including the options of migrating either one or both local development and microfinance programmes and activities to UNDP. It should be kept in mind that the success of UNCDF in its current programmes and activities depends to a large extent on its ability to make capital investments in order to pilot and lay the groundwork for replication or expansion in either local development or microfinance. In the options for the migration of UNCDF activities to UNDP, either an attribution of the capital investment mandate to UNDP would be necessary, combined with secure seed funding for investment activities, or the *modus operandi* of both the local

development and microfinance approaches would have to be reduced to their technical assistance functions, with the implied loss of their critical piloting and investment features.

IV. Proposed options for a future strategic niche and business model for UNCDF

12. The four options are presented in brief below, including the relevant analyses of the situation; vision, goals and strategies; products and services; niches and comparative advantages; institutional status, governance and management arrangements; funding requirements and arrangements; organizational structure, staffing and administrative support arrangements; opportunities and risks; and factors for success.

Option 1. An independent UNCDF focused on microfinance

13. The Executive Board, in its decision 2004/27, requested "the Administrator, in close consultation with UNCDF and Member States, to further elaborate on the viability and feasibility of options 1 and 2 in DP/2004/46, taking into account the concerns expressed by the Executive Board".

14. This option calls for UNCDF to specialize in the area of microfinance and the development of inclusive financial sectors. It is envisioned that the programme strategy and nature of the current UNCDF microfinance portfolio would not be changed, but would be expanded and scaled up, depending on resource availability, to a larger number of programme countries in order to enhance coverage and impact. Under this option, UNCDF would continue to rely on voluntary core and non-core contributions from member countries to finance its activities, as at present, in addition to leveraging capital from development banks and private sector. Alternatively, the funding model for core resources could be adjusted to reflect a further financial integration into the United Nations system or UNDP.

Situation analysis

15. Estimated at around one billion people, the global demand for microfinance services is largely unmet, with only about 40-50 million people reported to have access to sustainable microfinance services in 2002. The United Nations Secretary General has noted that "the stark reality is that most poor people in the world still lack access to sustainable financial services, whether it is savings, credit or insurance".[2]

16. Why are so many bankable people still 'un-banked'? There is a general consensus that "the key bottleneck is the shortage of strong (microfinance) institutions and managers. Public and private investments in microfinance should focus on building this capacity, not just moving money".[3]. Another major constraint is the lack of an enabling economic, political and legal environment allowing pro-poor financial services to be delivered on a sustainable basis. Only around 2 per cent of an estimated 10,000-15,000 microfinance operations and institutions worldwide are considered to operate in a professional and fully sustainable manner. The Microfinance Donor Peer Review conducted in 2003

[2] United Nations Secretary General Kofi Annan, 29 December 2003, announcing 2005 as the International Year for Microcredit
[3] Key principles of microfinance. CGAP. Key principle 10.

concludes that continued donor support to build financial systems that work for the poor remains vital.

17. The Programme of Action for Least Developed Countries specifies that LDCs should take concrete actions to support microfinance programmes and the development of an appropriate legal and regulatory framework[4], and calls upon development partners to support the efforts of LDCs in the areas of financial sector development and reform and in improving access of the poor to credit[5].

Vision, goals and strategy

18. UNCDF aims to become a recognized leader in building inclusive financial sectors in the LDCs. Between 2005 and 2010, UNCDF would support at least 20 LDCs in developing the financial infrastructure needed to provide financial services to the vast majority of poor and low-income households and micro and small businesses. UNCDF would support the governments of these LDCs to establish national strategies and policies conducive to the development of an inclusive financial infrastructure. UNCDF aims to provide capacity building and capital support to at least 50 microfinance institutions (MFIs) and/or microfinance units of local banks, at least 25 of which will be fully self-sufficient in 2010. At least 20 MFIs will have national coverage in 2010. The MFIs supported by UNCDF will have an active client base of more than five million customers by 2010.

19. *Branding*. UNCDF would brand itself as a multi-lateral organization that is specialized in building inclusive financial sectors in LDCs. In particular, UNCDF would focus its investments and activities on supporting the development of young and emerging microfinance sectors[6].

20. *Building enabling environments*. UNCDF, in collaboration with UNDP, would support countries to formulate and implement national policies and action plans to address the constraints that hamper the development of the microfinance sector. UNCDF would bring together key stakeholders like central banks, commercial banks, microfinance institutions (MFIs), bi-lateral and multi-lateral donors to formulate and implement national action plans to build inclusive financial sectors[7].

21. *Building sustainable microfinance institutions*. UNCDF would invest in building the institutional and human capacity and capital base of financial institutions that provide microfinance. The objective is for these institutions to become fully sustainable and able to attract funding from semi-commercial and commercial sources, including deposit taking, so as to be able to continue to expand their outreach and range of services.

22. *Close collaboration with UNDP*. UNCDF would work in close collaboration with the UNDP at all levels. At the central level UNCDF would remain the policy adviser to UNDP on microfinance. UNCDF would continue to represent UNDP at the Consultative Group to Assist the Poorest (CGAP). If

[4] Programme of Action for Least Developed Countries, Commitment 7: Mobilizing financial resources, page 49
[5] Programme of Action for Least Developed Countries, Commitment 7: Mobilizing financial resources, page 50
[6] See: www.uncdf.org/english/microfinance/sectorDev/index.php for a description of stages in sector development.
[7] See: www.uncdf.org/english/microfinance/sectorDev/index.php.

feasible, UNCDF would develop and implement regional programmes with the UNDP regional bureaux[8].

23. *Partnerships.* UNCDF would continue to coordinate its work closely with other United Nations organizations active in microfinance such as the International Fund for Agricultural Development (IFAD) and the International Labour Organization (ILO). UNCDF would maintain and develop strategic partnerships, including public-private partnerships with private sector institutions to address the constraints that exclude people from participating in the financial sector. UNCDF would work closely with donors, commercial and semi-commercial funds to increase the capital flow to LDCs.

24. *Decentralization.* To strengthen collaboration and coordination with partners in the field UNCDF would decentralize most of its technical management from the head office to the regions and countries.

25. *Technical advisor to UNDP worldwide.* An independent study by CGAP has found that none of the UNDP projects in microfinance that lacked the support of UNCDF were rated as strong. UNCDF could continue to be the technical advisor in the area of microfinance and inclusive financial sectors for UNDP worldwide, provided that: (a) UNCDF uses its resources first and foremost for LDCs and continues to brand itself as an organization for the LDCs; (b) the cost of the technical assistance to non-LDCs is borne by UNDP; and (c) the countries are in the start-up or emerging phase[9][1] in the development of their microfinance sectors, which are the niche areas for UNCDF microfinance products and services.

Products and services

26. UNCDF would provide the following products and services under this option:

(a) *National policy, strategy and programme design.* Sector assessments at the country level would serve to identify constraints and untapped opportunities that must be addressed to allow for full participation of the lower segments of the market into the financial sector. A national policy, strategy and action plan would be designed to develop a shared vision for building a competitive, efficient, and inclusive financial sector. UNCDF would design country programmes to support these frameworks and serve as the vehicle for investment by UNDP, UNCDF and other donors. UNCDF would assist in building local strategic partnerships through its network of CGAP member donors and other investors.

(b) *Investment in MFIs, building potential market leaders and competitive microfinance sectors.* UNCDF would invest in MFIs and in the microfinance units of commercial banks that wish to move into the provision of financial services to poor and low-income clients. UNCDF would build its institutional capacity in such areas as governance, risk management, business plans, product/market studies, management information systems, internal

[8] UNCDF has developed a joint $40-million regional programme with the Regional Bureau for Africa (RBA), financed by the RBA regional programme, UNDP country offices and UNCDF. The programme is managed from UNCDF offices based in Dakar and Johannesburg. UNCDF aims to develop similar programmes with the other regions, in particular the Arab States and Asia and the Pacific. At country-level UNCDF will continue to have joint programmes with UNDP.

controls and capitalization. UNCDF would provide grants, training and soft loans in local currency. UNCDF would tailor its standard performance-based grant agreements with MFIs, specifying key targets that MFIs must meet in order to continue receiving funding. Standard reporting formats for the MFIs (operational and financial performance) would allow local committees and potential donors and commercial investors to monitor performance through a globally accessible web-enabled database. The MicroStart programme modality would be an option available for building 'investable' MFIs.

(c) *Investment in building an environment conducive to the development of an inclusive financial sector.* Based on the environmental constraints identified in the sector assessment, the national action plan and periodic updates, UNCDF would invest in initiatives that aim to remove those constraints. For example, investment activities may include dialogue with governmental and non-governmental stakeholders on enabling policy and support to the development of enabling legal and regulatory frameworks that encourage mainstream banking institutions to engage unbanked populations with savings, lending and other financial services. Where appropriate, UNCDF may support the capacity building of a specialized microfinance unit in a central bank by providing technical support and facilitating discussions with central bank units in other countries.

(d) *Contracting technical service providers.* The CGAP review of the UNDP microfinance portfolio found that UNCDF involvement in contracting technical service providers was a key to success. UNCDF Microfinance would carry out international competitive bidding; including results-based contracts with technical service providers.

(e) *Research.* UNCDF and the Financing for Development Office of the United Nations Department of Economic and Social Affairs (UNDESA) would lead a process with global outreach to identify key constraints and opportunities for the promotion of inclusive financial sectors. These two entities would be supported by an inter-agency team composed of representatives of the World Bank, the International Monetary Fund (IMF), the ILO and IFAD, as well by input from other financial-sector experts. It is anticipated that this research (known as the 'Blue Book on building inclusive financial sectors') would serve as a guideline for developing action plans at the country level to build inclusive financial sectors. UNCDF would conduct periodic research on issues related to building inclusive financial sectors.

Niche and comparative advantage

27. The UNCDF niche is in supporting countries in the development of microfinance sectors that are in the start-up or emerging phase. The majority of these countries are LDCs, including those emerging from post-conflict or crisis situations. In these phases the emphasis is on building the human and institutional capacity and the capital base of microfinance institutions with the objective that they become fully self-sustaining. At later stages, when the microfinance sector matures and sound microfinance institutions are created, the microfinance industry would become self-reliant. Experience shows that a strong microfinance industry operating in a conducive environment is able to

attract deposits and commercial loans to further fuel its growth. The dictum is: "Capacity leads, capital follows".[10]

28. Another major challenge in these phases is to create an enabling environment for the sector to develop. These stages are often characterized by policies and regulations that are not conducive to the development of the sector and also by a lack of coordination among donors and government agencies. Through its sector development approach UNCDF is well positioned to invest in the sector in these stages by supporting governments and other stakeholders in the development and implementation of a national policy and action plan, and by investing in MFIs that have the potential to become self-financing and serve a large client base.

29. UNCDF has the following comparative advantages[11] in implementing this option:

(a) Strong staff capacity and internationally recognized technical competence in microfinance;

(b) UNCDF is mandated as a pioneering and risk-taking investment fund in the LDCs first and foremost;

(c) Neutrality, which together with UNDP access, neutrality and local-level networks, makes an excellent combination for building inclusive financial sectors;

(d) Demonstrated accountability for results and a proven track record operating in the LDCs;

(e) A range of flexible instruments for supporting MFIs in the early stages of development, including the ability to make capital grants and/or loans (UNCDF is the only United Nations organization that can provide loans directly to MFIs); and

(f) Strategic clarity in its niche of countries that are in the start-up or emerging phase of microfinance-sector development, the majority of which are LDCs.

Institutional status, governance and management

30. Under this option, UNCDF would remain an independent United Nations organization, reporting to the Executive Board through the Administrator, who serves also as managing director of UNCDF. The programmes and activities of UNCDF in local development would be migrated to UNDP (see option 2 below), together with the personnel and staff functions related to them, under UNDP management.

Funding requirements and arrangements

31. The funds required for UNCDF programming and operations are to be financed by multi-year core and non-core commitments from donors. The possibility of covering the core part of this base funding requirement through assessed contributions from the United Nations or core contributions from the

[10] A good example is the ACLEDA Bank that started as a UNDP project and, once their capacity was in place and a supportive regulatory environment created, they mobilized considerable funding from private sources. http://www.cgap.org/direct/docs/case_studies/cs_14.pdf

[11] Headings are made in line with the core elements of donor effectiveness that help determine an agency's comparative advantage and niche in microfinance vis-à-vis others. These core elements are agreed upon by the members of the CGAP Aid Effectiveness Initiative. Elements of Donor Effectiveness in Microfinance: Policy Implications. April 2004

UNDP biennium budget may also be explored. The total amount of yearly base funding required would be $12-13 million (see table 1 below).

Table 1. Microfinance financial projections (in millions of dollars)

Income and expenditure	2004	2005	2006	2007	2008	2009	2010
Income							
UNCDF core/non-core funding	6.4	11.7	12.4	12.6	12.7	12.9	13.0
UNCDF tech. advisory services	0.08	0.2	0.2	0.2	0.2	0.2	0.3
UNCDF exec./impl. fees	-	-	0.8	0.8	0.8	0.8	0.8
UNCDF interest on loans	0.03	0.1	0.3	0.5	0.7	0.9	1.0
UNDP reg. programmes/SURFs	1.3	3.9	5.0	5.0	5.0	5.0	5.1
UNDP country programmes	1.3	3.9	5.0	5.0	5.0	5.0	5.1
Total income	**9.11**	**19.8**	**23.7**	**24.1**	**24.4**	**24.8**	**25.3**
Expenditure							
Salaries headquarters staff	3.0	3.2	1.9	1.9	2.0	2.1	2.2
General operating expenditure	0.7	0.7	0.6	0.6	0.6	0.6	0.6
Subtotal headquarters	3.7	3.9	2.4	2.5	2.6	2.7	2.8
Regional and country programmes							
Africa	5.0	9.7	11.8	11.8	11.9	11.9	11.9
Asia and Pacific	-	3.0	4.1	4.2	4.2	4.2	4.2
Arab States	0.4	3.0	4.1	4.2	4.2	4.2	4.2
Latin America							
Europe and the CIS							
Sub-total programmes	5.3	15.7	20.0	20.1	20.2	20.3	20.3
Total expenditure regional and country programmes and HQ	9.0	19.6	22.4	22.6	22.8	23.0	23.1
Miscellaneous programmes	0.1	0.3	1.3	1.5	1.7	1.9	2.1
Total expenditure	**9.1**	**19.9**	**23.7**	**24.1**	**24.5**	**24.9**	**25.2**

32. Voluntary core contributions from donors would be leveraged by non-core contributions and funds from development banks and the private sector. As an example, in the first sector development programme, in Sierra Leone, UNCDF is on target to leverage its own funds by a multiple of seven. Through its vast network of donors and commercial investment funds, UNCDF would mobilize additional resources to support UNDP and UNCDF joint country programmes. UNCDF targets a total of more than $100 million in additional capital to be mobilized in the regional programme for Africa in support of the objectives of the programme. The UNCDF partnership with the UNDP Bureau for Crisis Prevention and Recovery is expected to result in additional funding

to support the development of microfinance sectors in post-conflict and crisis countries.

Organizational structure, staffing and administrative support arrangements

33. UNCDF would have a small team at the Head Office consisting of an executive secretary, a director of microfinance, a deputy director of microfinance, a small support team to manage the finances and responsibilities of UNCDF as an implementing agency (finance officer – executing agency, operations/portfolio manager and operations/finance/human resources associate) and an advisor in strategic partnerships and communications. An administrative and a programme assistant would support the secretariat. Where feasible, UNCDF would negotiate the provision of support services (human resources, evaluation, etc.) from UNDP. At the regional centres, UNCDF would establish teams of regional managers, technical managers and support staff. The size of the team would be dependent on the size of the regional programme.

Opportunities

34. This option presents considerable opportunities to UNCDF, including to:

(a) Replicate the joint UNCDF/UNDP Africa regional programme in other regions;

(b) Increase the visibility of UNDP and UNCDF's microfinance operations through the launch of the Year of Microcredit in 2005;

(c) Support concretely the global efforts to attain the MDGs and the goals within the Programme of Action for LDCs;

(d) Implement key aspects of the report of the Commission on the Private Sector and Development that stress the importance of microfinance;

(e) Help MFIs in LDCs to access the rapidly increasing number of private and public funds wishing to invest in sound microfinance institutions; and

(f) Capitalize on the positive response from programme countries and UNDP country offices for the UNCDF sector development approach, in which the first six sector programmes in Africa have already mobilized $10 million in commitments and pledges from UNDP country programmes.

Risks

35. The risks associated with this option are:

(a) Resources from donors may remain at the current level for microfinance activities of UNCDF, which is insufficient to implement the planned programmes effectively;

(b) Resources may not be available at the required levels and at the beginning of the year as per funding agreements;

(c) 'Normal' business risks when working in LDCs with a microfinance sector in the start-up or emerging phase, including LDCs emerging from post-conflict or crisis situations; and

(d) Some potential financial and public relations risks in mobilizing commercial capital to support UNCDF-'nurtured' MFIs that may fail.

Factors for success

36. The factors determining the success of this option are:

(a) UNCDF would require a minimum of $12 million per annum in grant fund support from UNDP and donors in multi-year funding agreements;

(b) The development of a resource mobilization strategy that effectively brands UNCDF as a multilateral organization is specializing in building inclusive financial sectors in LDCs;

(c) The incentive system for UNDP country offices needs to be adjusted so that resources invested by UNCDF are credited on the country office resource mobilization scorecard. Similarly, UNDP country offices need to be credited for cost sharing and trust funds that donors choose to programme through UNCDF for their countries;

(d) Regional programmes and country programmes are formulated and implemented jointly with UNDP.

Option 2. UNCDF programmes and activities in local development are migrated to UNDP

37. The Executive Board, in its decision 2004/37, requested the Administrator, "in order to facilitate a final decision on the proposal, to elaborate, in close consultation with members of the Executive Board and other key stakeholders and partners, a detailed proposal on the organizational arrangements (business plan) of the future centre, including its management, staffing, programming and funding arrangements and an assessment of opportunities and risks involved, resource projections and factors of success, to be presented to the Executive Board at its first regular session in January 2005".

38. This option calls for the migration of current UNCDF programmes and activities in local development to a new unit in UNDP, the UNDP Centre for Local Development (CLD). It is envisioned that the programme strategy and nature of the current UNCDF local development portfolio would not be changed, but would be expanded, deepened and scaled up, depending on resource availability, to a larger number of LDCs in order to enhance coverage and impact. The CLD, under this option, would rely on voluntary contributions from member countries to *UNDP* to finance its activities.

Situation analysis

39. The initial analysis of the Millennium Project, whose report is due in early 2005, indicates that in developing countries the most important step to achieving the MDGs is a significant increase in investment rates, both public and private. At the core of a national strategy to achieve the MDGs, developing countries need a strategy for greatly increased investments in infrastructure, human capital, and the private sector. This would entail good governance, a strategy to scale up investments, and increased financing – largely donor financing – for public investment in the poorest countries. The spread of HIV/AIDS and infectious diseases has placed added demands on services at the local level, while the spread of armed conflict in Africa has its root causes in weak local governance and insufficient investment at the local

level. Investment in local development and local governance is therefore central to meeting the MDG challenge. Building the capacity of local governments to manage decentralized functions and resources is also central to implementation of poverty reduction strategies (PRSs). While many actors are involved at the policy level to support developing countries in defining their PRSs, building effective mechanisms to implement them, particularly at the local level, remains a bottleneck in translating PRSs into concrete development results.

40. The current local development piloting activities of UNCDF are faced with the challenge of securing basic financial needs, including, among other things, core resources for the *critical organizational mass* required to formulate and manage programmes. The annual delivery of poverty-reducing investments from core resources has been cut back from an average of $40 million in the 1990s to $15 million in 2004, reducing both their impact on poverty and the credibility of pilot projects. The rate of annual programming in local development has also been reduced, from an average of 10-12 projects a decade ago to just five in recent years. Average project size has shrunk from about $5 million to $0.5-1 million, and the total number of LDCs served has fallen to 25. If this trend continues, in a few years time the size of the portfolio, the number of LDCs covered and the annual delivery would have dwindled to levels that would not justify the existence of an organization dedicated to their management.

41. This severe financial decline stands in contrast to the increasing demand for local development and governance assistance in LDCs. The demand for local development exceeds the ability of UNCDF to respond, and numerous requests from LDCs have been turned down due to insufficient resources. The option of establishing the CLD in UNDP builds on the potential implicit in the markedly increased demand for the service line.

Vision, goals and strategy

42. The CLD aims to be recognized as the lead organization focusing on LDCs for local governance, making demand-driven investments in local development and decentralization in LDCs. Its investments would be innovative and risk-taking and would seek to realize the objectives of the Brussels Plan of Action for LDCs and the achievement of the MDGs at the local level.

43. *Branding*. The CLD would brand itself as a multilateral organization specializing in local governance for LDCs only. In particular, the CLD would focus its investments and activities on promoting local development and decentralization to reduce poverty in up to 40 LDCs.

44. *Building enabling environments*. The CLD, in collaboration with UNDP, would support countries to formulate policies that foster local governance, decentralization and poverty alleviation at the local level. The CLD would bring together key stakeholders such as central government, sectoral ministries, local authorities, non-governmental organizations, and bilateral and multilateral donors to formulate and implement local governance programmes.

45. *Capacity-building*. In close cooperation with UNDP, the CLD would invest in building the institutional and human capacity and capital base necessary for successful decentralization policies.

46. *Partnerships.* The CLD would work with other United Nations organizations active in local governance, local development or decentralization such as UNDP and UNDESA. The CLD would maintain and develop strategic partnerships with research and academic institutions in the South to foster South-South cooperation, and would seek co-financing arrangements with donors to increase investment flows to LDCs.

47. *Funding.* To cover up to 40 LDCs, the CLD will need core funding of about $16 million a year, of which less than $3 million would be for administrative costs at headquarters. Non-core financing is expected to reach about $43 million a year.

48. *Decentralization.* To strengthen collaboration and coordination in the field, the CLD would decentralize most of its programme managers and technical advisors by posting them in countries where UNDP has regional support centres (Bangkok, Dakar and Johannesburg).

49. *Technical adviser to LDCs.* The CLD would sub-contract its technical advisers to other bi- or multi-lateral development organizations (the World Bank, UNDESA and Belgian Technical Cooperation, among others) for the formulation and implementation of local governance programmes in LDCs.

Products and services

50. The primary products of the CLD to strengthen central and local institutional capacity for infrastructure and service delivery in the LDCs would be the delivery of capital grants, concessional loans, and substantive technical and managerial expertise.

51. The CLD would deliver the current UNCDF local governance service lines, supporting and strengthening local government capacity to deliver services in the areas of health, education and water, among others, and to create a local environment conducive to the growth and proliferation of economic opportunities, including through the creation and strengthening of basic economic and social infrastructures. The trademark product, local development programmes (LDPs), developed as a result of the reforms of the late 1990s by the Local Governance Unit of UNCDF, links capital investments in services delivery systems and small-scale urban and rural infrastructures to institutional change and the building of local capacity for improved governance, the promotion of local development and reduction of poverty.

52. Much of the assistance provided by CLD would be cast as strategic support to institutional innovation in decentralized planning and financing for rural service delivery. The CLD would promote broader local participation in public affairs, increase the accountability of elected politicians and civil servants, and foster greater collaboration among local institutions (public, private, community and civic). The CLD would invest in locally managed development programmes in poor areas to improve infrastructure, expand access to high-quality services, protect and manage natural resources, and promote local economic activity. It would also strengthen and promote institutions of decentralized planning, financing and management of local development, thereby piloting and supporting the implementation of national decentralization reforms and furthering the policy dialogue agenda of UNDP.

Niche and comparative advantage

53. Over the last decade, experience has demonstrated two major comparative advantages of the present Local Governance Unit in UNCDF:

(a) Its expertise in crafting and supporting 'policy-relevant' small-scale local development programmes, designed in partnership with national and local authorities and civil society, is a highly effective strategy for promoting policy reform and leveraging replication by partners;[12] and

(b) Its mandated ability to match technical assistance with capital funding has been critical in order to build hands-on local capacities; develop real-time innovations in local institutions, systems and procedures; deliver pro-poor infrastructures and services; and pilot policy reforms for wider adoption.

54. The CLD would build on these two key areas of comparative advantage, scaling up the size and geographical spread of interventions in the LDCs. This would reinforce its distinct identity within UNDP and in the international development financing architecture as an organization with comparative advantage in LDCs. The CLD would reinforce partnerships within and among programmes in UNDP, investing in hard-to-reach and poor areas to achieve the MDGs at the local level.

55. The CLD would collaborate and build partnerships with UN-Habitat, UNDESA, IFAD, the FAO Investment Centre, the World Bank and the global alliance of local governments, United Cities and Local Governments. The Centre for Local Development would become the UNDP 'centre of excellence' in local development, focusing on a piloting role in capital assistance that would form the basis of partnership and collaboration with local and central governments and bilateral and multilateral assistance.

Institutional status, governance and management

56. Since the CLD would be fully integrated into UNDP, it would be under UNDP governance arrangements and the director of the CLD would report to the Directorate of the Bureau for Development Policy (BDP), while establishing matrixed-management arrangements with the regional bureaux.

57. Day-to-day management of the CLD would be under the overall guidance of a director. Overall policy development, operations, preservation of standards and accountability for the achievement of programme results for the CLD would be the responsibility of the director, who would also take on an active role in resource mobilization in collaboration with BRSP.

58. Two possible options present themselves within UNDP in terms of the physical location of the CLD: continued location in New York to maximize synergies with other UNDP programme units and to facilitate reporting and governance arrangements; or relocation to Europe (e.g., Brussels, Geneva or Paris), where it would be closer to programme clients and the potential of increased non-core resources could be enhanced through substantive programming with interested donors.

[12] UNCDF local development programmes were cited by the OECD/DAC, in a recent review of 19 multilateral and bilateral decentralization support programmes, as demonstrating "the only example" of support to *sustainable* decentralization, with the approach replicated nationwide in a number of countries. See *Lessons Learned on Donor Support to Decentralization and Local Governance*, available at http://www.oecd.org/dataoecd/46/60/30395116.pdf.

Organizational structure and staffing

59. At the outset, the setup of the CLD would not require the establishment of new posts and most of the current staff (a mix of programme managers, programme officers, and technical experts)[13] of the UNCDF Local Development Unit would be reassigned to the newly created CLD. Monitoring and evaluation, financial management and general administrative services would be provided by UNDP. BRSP would coordinate resource mobilization for core resources, although non-core resource mobilization would be monitored and analyzed closely by the Directorate of the CLD. In subsequent years, the staff would need to be increased as the CLD expands its geographic coverage to an increasing number of LDCs and mobilizes sufficient non-core resources to ensure that it can increase the number of projects under management as well as their average size. Programme officers would be fully integrated into UNDP country offices. They would be funded from project support costs and would vary in number and location according to demand and programme development needs.

Financial requirements and arrangements

60. The total core resources required to make the CLD credible and viable are presented below, in table 2. The total administrative costs of establishing the CLD at the central level would be about $2.5 million per year, while the combined costs of CLD staff posted in the regional centres would be around $1.5 million per year[14]. The CLD would aim to have different sources of income: (a) UNDP biennium budget; (b) thematic global local development trust funds ($12-14 million per year); (c) country-level non-core resources from donor agencies, and private sector contributions ($24 million per year)[15]; and (d) cost-recovery for technical advisory services (about $0.5 million per year).[16]

[13] The staff have combined backgrounds in fiscal decentralization, rural-urban planning, rural development, community development, environmental governance, planning and performance budgeting, municipal management, and gender mainstreaming.
[14] Administrative costs of all UNCDF units amount to about $ 6 million.
[15] UNCDF/LGU mobilizes at least $10 million per year.
[16] Services provided by a limited number of technical advisers will generate revenues of about $0.4 million in 2004

Table 2. Financial and staffing projections for the Centre for Local Development

Assumptions, income and expenditures	*Units*	2005	2006	2007	2008	2009	2010
- Cumulative no. LDPs and total no. LDCs served	*LDCs*	29	33	37	40	40	40
- New programmes prepared	*LDCs*	8	10	12	12	12	12
of which in 'new' LDCs	*LDCs*	3	4	4	3	0	0
- Avg. core funding per project	*$m*	*1.2*	*1.2*	*1.2*	*1.2*	*1.2*	*1.2*
- Avg. co-financing mobilized per project	*$m*	*3.6*	*3.6*	*3.6*	*3.6*	*3.6*	*3.6*
- Avg. annual delivery from core per project/LDC	*$m*	*0.6*	*0.5*	*0.4*	*0.3*	*0.3*	*0.3*
- Avg. annual total delivery per project/LDC	*$m*	*0.9*	*1.1*	*1.3*	*1.4*	*1.4*	*1.4*
- Total annual new programming from core	*$m*	9.6	12.0	14.4	14.4	14.4	14.4
- Total annual programming – core + non-core	*$m*	38.4	48.0	57.6	57.6	57.6	57.6
- Headquarters staff	*Staff*	12	12	12	12	12	12
- Regional centre staff	*Staff*	6	10	10	10	10	10
- UNDP biennium budget (org./staff costs + $12 m – country TRAC)	*$m*	15.4	16.1	16.3	16.5	16.7	17.0
- Global trust funds	*$m*	9.6	12.0	14.4	14.4	14.4	14.4
- Country-level non-core mobilized	*$m*	19.2	24.0	28.8	28.8	28.8	28.8
Headquarters staff and org. expenditures							
- Headquarters staff salaries	*$m*	1.8	1.9	2.0	2.1	2.2	2.3
- Headquarters staff – general operating expenditures	*$m*	0.5	0.6	0.6	0.6	0.7	0.7
Subtotal Headquarters	*$m*	2.4	2.5	2.6	2.7	2.9	3.0
Regional staff and org. expenditures							
- Regional centres – staff salaries	*$m*	0.8	1.2	1.3	1.4	1.4	1.5
- Regional Centres – general operating expenditures	*$m*	0.2	0.4	0.4	0.4	0.4	0.5
Subtotal regional centres	*$m*	1.0	1.6	1.7	1.8	1.9	2.0
Other programme expenditure							
- Total country level programmes, of which	*$m*	26.1	36.3	46.3	54.0	54.0	54.0
country level programmes funded from core	*$m*	16.0	16.5	14.8	12.8	12.0	12.0
Country level programmes funded from non-core	*$m*	10.2	19.8	31.5	41.2	42.0	42.0
- Total research and development	*$m*	0.1	0.4	0.4	0.4	0.4	0.4
- Miscellaneous projects	*$m*	0.5	0.5	0.6	0.6	0.6	0.6

61. The table also provides the staffing and core funding implications of a CLD that is 'operationally viable'. A total annual expenditure of $52 million for local development in LDCs is projected for 2007, while non-core resources would have increased to $43 million and project size would be increased to an average of $5 million. While the size of programme management and technical staffing would have grown in order to attain the critical mass required to pursue non-core resources effectively, the proportion of administrative costs to resources under management will be 9 per cent by 2009.

62. A sine qua non for migration to UNDP in the form of an autonomous CLD is the contribution to its administrative and operational budget from UNDP biennium budget. The other sources of funding, including non-core resources for operations in the form of global and country office trust funds or third-party cost sharing, may be accessed in various permutations. The exact proportions of the CLD budget from each of these sources will be the subject of future detailed discussions.

63. Capacity building, technical services and investment operations would be provided on a grant basis. CLD grants would eventually become part of a larger investment-financing package including loans from other donors and national governments. A possible future soft-lending programme focusing on scaling up MDG investments would require additional funds for the creation of a reserve in order to offset the risks associated with lending. Such a reserve could probably be negotiated separately with member states and established over a period of time.

Opportunities

64. This option presents a variety of opportunities, including:

(a) A ready-made UNDP response mechanism, building on the momentum generated by the 2005 Millennium event, for addressing one of the main bottlenecks to achieving the MDGs identified in the Millennium Project analysis: investment at the local level in provision of basic social services and socio-economic infrastructure;

(b) More effective leverage of potential synergies in support of the UNDP corporate agenda, and scope for UNDP to contribute more directly and visibly to the implementation of the MDGs at the local level, and potentially to pilot implementation of PRSs at the local level;

(c) A stronger basis for experience-based practical 'policy lessons' to fuel and broaden the UNDP knowledge capital and policy dialogue agenda in some of its practice areas;

(d) An in-house UNDP operational capacity for the design and support of local development programmes, and greater scope for UNDP non-core resource mobilization and partnership around these programmes;

(e) Greater programme integration and collaboration at the country level in UNDP country offices;

(f) Contribution to the simplification and harmonization agenda, providing at the same time a modality for preserving and building on the demonstrated effectiveness of UNCDF local development programmes.

Risks

65. The risks associated with this option are:

(a) With the creation of the CLD, investment in the current brand name of UNCDF would be lost. This may, at least initially, impact on the ability of the CLD to mobilize non-core resources;

(b) After some time, there would be little leverage remaining on donors to continue 'additional funding' to UNDP to support the integrated CLD, as the identity and value of CLD work risk being lost in the wider UNDP. The same trend may also risk the CLD being seen less as a method to

protect the valuable local development work of UNCDF while responding to the simplification and harmonization agenda and funding issues than as just another unit competing for scarce UNDP resources;

(c) Potential dilution of the CLD role to encompass other types of investment-supported interventions across the UNDP practice areas, leading to a loss of focus and effectiveness;

(d) Potential risk that local development could become a cross-cutting theme mainstreamed by different units, with a loss of focus and autonomy of the CLD;

(e) Internal UNDP organizational rationale for the creation of an additional centre may be unconvincing. It may be argued on modality terms (retaining the capital funding modality of UNCDF requires setting up a separate 'ring-fenced' centre within UNDP), but the rationale for retaining a separate CLD and a BDP decentralization, local governance and urban/rural development practice sub-group within UNDP is still questionable. The risk of unproductive overlap or competition between the CLD and the practice group remain unresolved;

(f) Any negative change in the future financial status of UNDP would have an effect on the CLD – unless some form of 'internal earmarking' or a specific funding agreement can be agreed in advance;

(g) Political implications of the loss of UNCDF as the agency of the LDCs (CLD might not enjoy the political support and ownership of the LDCs);

(h) Other more generic risks typically associated with 'merger and acquisition' processes (e.g., human resources, management, operational, organizational culture and 'fit' issues);

(i) World Bank expansion of grantized international assistance and technical convergence with the UNCDF CLD approach threaten to undermine the CLD niche.

Factors for success

66. The factors that would ensure the success of this option are:

(a) A minimum of $16 million per annum in support from UNDP in multi-year funding agreements, and full commitment and responsibility on the part of the Administrator for resource mobilization for the CLD to ensure its continued financial viability;

(b) The development of a resource mobilization and marketing strategy for the CLD;

(c) In view of the ongoing changes in the architecture of development assistance, full and unwavering political commitment on the part of member states, and especially on the part of LDCs themselves, to a distinct centre devoted specifically to their needs is essential to its ability to fulfil its mandate and, indeed, to its long-term survival;

(d) Preservation of the UNCDF business model in local development within the CLD.

Legal implications

67. Since UNCDF is a creation and a subsidiary organ of the General Assembly, it is ultimately for the General Assembly, presumably upon the recommendation of the Executive Board and the Economic and Social Council, to decide on changes affecting its mandate. If the current UNCDF continues as an independent organization focusing on microfinance (see option 1 above), the legal changes required are limited to changes that would enable the CLD to provide capital assistance first and foremost in LDCs. Only when the creation of the CLD is accompanied by an integration of microfinance into UNDP (see option 4 below) would the current UNCDF mandate switch to UNDP, and UNCDF would go out of existence. The implications are that assets and liabilities (human, financial and property) would go to UNDP, so that the presentation of activities and financial reporting would be integrated into UNDP reporting.

Option 3. UNCDF is maintained as an independent agency focused on reducing poverty in the LDCs

68. The Executive Board, in its decision 2004/37, requested the Administrator of UNDP "to elaborate on other options, including maintaining an independent UNCDF, focusing on practice areas in accordance with its current mandate, and, in this connection, also elaborate on the possibility for UNDP to strengthen its assistance to UNCDF in its advocacy efforts to mobilize the necessary resources".

69. This option presents several sub-options for maintaining an independent UNCDF that address the critical issue of financial viability. Since the expressed interest of some members of the Executive Board for United Nations consolidation is directly affecting the financial viability of UNCDF, possible areas of further integration of UNCDF into the United Nations and UNDP are also explicitly discussed.

70. This option calls for the current mandate and institutional status of UNCDF to be maintained as is, with emphasis on branding UNCDF as the primary United Nations instrument for capital investments for the attainment of the MDGs in the LDCs, and with the support of UNDP to implement a resource mobilization strategy to further diversify and expand its funding base in order to ameliorate its current financial situation.

Situation analysis

71. The international consensus on the MDGs and the critical importance of their attainment in the LDCs have been cited earlier as comprising a strong rationale for the continuation of the two core businesses of UNCDF – local development and microfinance.

72. In the initial analysis of the Millennium Project, the most important step towards achieving the MDGs is identified as a significantly increased investment rate, both public and private. At the core of a national strategy to achieve the MDGs, the report advocates a strategy for greatly increased investments in infrastructure, human capital, and the private sector. Higher levels of resource commitments and investment call for a commensurate increase in the capacities at all levels to plan, manage and deliver such resources towards achievement of the agreed goals, especially at the local

level. Thus, an effective United Nations system-wide response to the MDG challenge in the LDCs would have to include investments in socio-economic infrastructure. This reconfirms the importance of the mandate, currently attributed to UNCDF, of investing in LDCs.

73. In response to the Millennium Declaration, as well as in response to armed conflicts and humanitarian crises, multilateral and bilateral official development assistance is expected to continue increasing in the coming years. Thus there are real opportunities for a significant increase in mobilizing core and non-core resources, both for programme funding and for implementation support – especially at the field level – for localizing the MDGs, for crisis prevention and post conflict support, and for bridging the gap between relief and development.

74. Another key issue relevant to the future of UNCDF is the United Nations reform agenda of simplification and harmonization within the United Nations family of organizations, which propels the move towards better coordination and consolidation of United Nations programmes and activities, and a better defined division of labour among United Nations organizations. Although interpretations of the agenda may vary, this ongoing discussion significantly affects institutional status and donor funding, particularly with respect to the smaller United Nations organizations. In this discussion, it is important to focus on the ultimate purpose of simplification and harmonization – to ensure greater development effectiveness – and not to equate it simply with the reduction of the number of agencies. From the above discussion on the importance of capital investment for the attainment of the MDGs in LDCs, it is clear that the mandate of UNCDF is worth preserving, preferably in the form of an independent and integrated United Nations organization.

Vision, goals and strategy

75. UNCDF is recognized as a focused, innovative and risk-taking United Nations fund, that makes demand-driven, small-scale investments in LDCs towards the realization of the objectives of the Brussels Plan of Action for the LDCs and the achievement of the MDGs at the local level, especially in those service lines and geographical areas that call for the neutrality and convening power of the United Nations.

76. The overall goal of UNCDF is to help reduce poverty in LDCs first and foremost. This overall goal of reducing poverty is served by two sub-goals related to the two core businesses of UNCDF: local development and microfinance. The specific programme goals are presented in the service line-specific options 1 and 2 above.

77. UNCDF has specific investment strategies to achieve its two sub-goals. These are outlined in detail earlier in this document. Additional strategies to support new sub-goals and lines for investing towards the achievement of the MDGs in LDCs, such as support to local private sector development, may be developed, provided that there is real programme-country-level demand, matched by adequate funding, and that the new service lines build upon the comparative advantages of UNCDF.

Products and services

78. UNCDF products and services in its two service lines are described earlier in this document.

Niche and comparative advantage

79. In responding to the MDG challenge, UNCDF, as an independent organization, fills a specific niche in the international development architecture.

(a) *Substantive niche.* As described earlier, UNCDF has effectively established its substantive niches in local development and microfinance.

(b) *Organizational niche.* The UNCDF niche in organizational terms is partly derived from its status as an independent United Nations organization with a legal mandate, political support, financial framework and technical expertise different from and complementary to those of UNDP and other United Nations organizations. At the same time, UNCDF benefits from the fact that it is fully integrated in the UNDP group in areas such as governance, programming arrangements, physical location and human resource management.

80. UNCDF, as an independent organization, has a number of distinct comparative advantages within the United Nations system and the UNDP group. These include the following:

(a) *Unique legal status.* UNCDF has a specific mandate to provide capital assistance by means of grants and loans, enabling it to fund investments in both the public and private sphere using a variety of investment instruments. UNCDF is also mandated to invest first and foremost in the LDCs.

(b) *Strong political support.* The governments of LDCs value UNCDF as an organization that develops effective products and delivers results that are prioritized by and fully appropriate for the LDCs. Their demand for UNCDF interventions systematically surpasses the capacity of UNCDF to respond.

(c) *Financial flexibility.* Voluntary contributions to UNCDF cover both biennium and programme budgets, providing for a central fund of investment resources, which are used catalytically to invest behind innovative ideas and high-risk investments with potential for larger scale replication by others, as well as to leverage additional, non-core programme resources.

(d) *Highly specialized and respected technical expertise.* UNCDF has a critical mass of highly specialized experts in both local development and microfinance working as solid knowledge teams with a shared vision and common approaches. These experts are well connected and networked in their sectors, and are widely respected.

(e) *Excellent integration into the United Nations and UNDP frameworks in terms of governance, programming, physical location and human resource management.* UNCDF has a close and harmonious relationship with UNDP at headquarters, regional and country levels. The programming framework of UNCDF is fully aligned with the UNDP group and with the United Nations system and is consistent with the overall drive for United Nations simplification and harmonization. At the country level, UNCDF interventions are part of the United Nations and UNDP programming frameworks at the country level, i.e., the common country assessment, the United Nations Development Assistance

Framework, country programme action plans and country cooperation frameworks.

(f) *Strong complementarity with UNDP and other partners in joint programming.* The substantive and organizational comparative advantages of UNCDF are optimized when the capital investments and technical expertise of UNCDF complements the technical assistance and policy advocacy support of UNDP and other partners in joint programmes to produce good results on the ground.

Institutional status, governance and management

81. This section presents the different institutional, governance and management options for maintaining an independent UNCDF and addresses the primary issue of financial viability. Since the expressed interest of some members of the Executive Board in United Nations consolidation directly affects the financial viability of UNCDF, this section presents several 'sub-options' involving different degrees of integration into the United Nations or UNDP that may be considered as possible solutions to the problem of financial viability.

82. *Sub-option 1. Status quo.* UNCDF resource mobilization efforts have focused in the past few years on achieving the target of $30 million in voluntary core contributions to form the backbone for financing both administrative support and programme budgets. However, the actual trend in UNCDF core contributions is downwards, largely due to reasons beyond its control. Continuation of the current resource mobilization strategy might lead to a loss of financial viability and independence over time, as UNCDF struggles to get the required minimal level of core and non-core resources to enable it to operate. Under current conditions, the apparent financial insecurity inherent under this option would not permit UNCDF to fulfil its mandate.

83. *Sub-option 2. Increased diversification of funding sources.* In order to mobilize core and a wide spectrum of non-core resources for UNCDF, UNDP would provide active support to UNCDF in resource mobilization and advocacy, while respecting the comparative advantages of UNCDF. To increase core resources, focus would be on broadening the UNCDF funding base, such that a majority of G-8 countries join the group of donors that provide more than $1 million per year to UNCDF. UNDP and UNCDF would together explore the potential to attract new donors for UNCDF in the Eastern European region and among members of the Group of 77. UNDP and UNCDF would work together in order to increase the non-core resources of UNCDF (details outlined in paragraphs 91 and 92).

84. *Sub-option 3. Financial integration into the United Nations.* Under this option, a decision would need to be made by the General Assembly to provide assessed contributions for UNCDF to cover its administrative budget and part of its programme budget. This would entail a change in governance arrangements, with a specific role for the Fifth Committee in the oversight of UNCDF. The same non-core scenario as for sub-option 2 applies.

85. *Sub-option 4. Financial integration into UNDP.* Under this option, UNCDF and UNDP respond to the call for further United Nations consolidation by adopting a strategy of the gradual financial integration of UNCDF into UNDP, as is the case with the United Nations Volunteers (UNV) programme, while UNCDF remains an independent legal entity so as to

continue to maintain its capital investment mandate and other comparative advantages, such as flexibility and visibility, inherent in its current independent, small-organization status. As a matter of policy, UNDP does not support earmarked voluntary contributions to regular core resources. Hence, increased financial integration in UNDP would consist of the inclusion of the UNCDF base structure in the UNDP biennium budget for 2006-2007 and onwards. On the non-core side, this option is the same as for sub-option 2 and 3e. The possibilities and prospects for UNDP to contribute financially to UNCDF, should the Executive Board wish to pursue this sub-option further, will, of course, need to be carefully evaluated. In this respect, the present core funding scenario for UNDP, though improving, is not yet at an optimum level. The legal implications of pursuing this sub-option will also have to be kept in mind. The feasibility of direct UNDP funding to UNCDF, whether for programme or administrative support, will be influenced by these and other factors.

86. On the legal side, there would appear to be three options: (a) keeping the UNCDF mandate as is; (b) integrating the UNCDF mandate into the UNDP mandate; or (3) taking the decision that the mandate is no longer considered relevant. However, it is clear that, irrespective of a possible financial integration of UNCDF in the United Nations or UNDP, no changes in the legal independence of UNCDF could be made without giving up the 'independent' UNCDF. Further, this would require a decision from the General Assembly.

Funding requirements: the financial framework for all sub-options

87. The financial framework for the different sub-options is based on the following assumptions:

(a) *Growth in total programme resources* to enable the United Nations to respond to LDC demand for increased levels of investment in local development and microfinance;

(b) *Application of the principles of results based budgeting.* The funding required for an independent UNCDF is budgeted against the two basic product lines with corresponding core results, by adding the resources required for two service lines, local development and inclusive financial services, while taking into account a limited additional budgetary requirement to enable UNCDF to fulfil its statutory functions in the area of oversight;

(c) *Acceptance of the base structure* plus augmentation concept and further decentralization;

(d) *Core resources are used as the basis for mobilizing non-core resources*, using a factor of 1 to 3 for local development and 1 to 2 for microfinance;

(e) *Core resources should not be used to subsidize management of non-core resources.*

88. Based on the detailed performance budgets outlined in options for integrating local development and microfinance, the administrative resources required for a small base structure would be about $5 million per year for 2006-2007 (down from $7 million in 2004-2005). UNCDF core programme resources, dedicated first and foremost to LDCs, would have to be around $18 million core (present level) and $48 million non-core for 2006-2007 (four

times the current level). The total amount of yearly funding needed for the base structure, technical expertise and investment purposes would therefore be around $71 million, out of which $22 million would be financed out of contributions to the core.

89. The above amount excludes: (a) funding from UNDP for the capacity building part of the joint programmes; and (b) the leveraging of these resources in parallel funding from other donors, development banks and the private sector for investments in growth of MFIs, and scaling up and replicating local development programmes.

Table 3. Independent UNCDF resource planning for 2006-2007

Income per year (in millions of dollars)	**Local development**	**Microfinance**	**Total**
Core funding: base structure (5.0) + programme (17.0)			22.0
Interest			1.0
Non-core local development	36.0		36.0
Non-core microfinance		12.0	12.0
TOTAL			71.0
Expenditures per year (in millions of dollars)	**Local development**	**Microfinance**	**Total**
Core: base structure at headquarters			5.0
Core: programming from core	12.0	6.0	18.0
Non-core: programming from non-core	36.0	12.0	48.0
Total			71.0

90. Depending on the choice of sub-option, core and non-core funding would come from a mixture of the following (see also annex 2):

(a) Core: assessed contributions;
(b) Core: voluntary contributions, directly to UNCDF; and/or
(c) UNDP biennium budget (starting 2006 / 2007); and/or
(d) Non-core resources;
(e) Technical Advisory Services.

91. To increase non-core resources, UNDP and UNCDF would seek to actively encourage and promote joint UNDP/UNCDF programming at the country, regional and global levels and ensure that UNCDF is consulted and fully integrated into the CCA/UNDAF processes and country programmes. UNCDF would also be involved in MDG and post-crisis needs assessments in LDCs, especially in analyzing local investment options and planning for local-level development. UNCDF local-level development work could be marketed alongside similar UNDP programmes, including Capacity 2015, the small grants programme of the Global Environment Facility, UNV, and local level public-private partnerships initiatives, to show donors and the United Nations system at large a focused, integrated set of services available through the UNDP group. While this collaboration already happens on an ad hoc basis, it is not reflected in effective headquarters arrangements for joint non-core resource mobilization.

92. At the global level, UNCDF would use the thematic trust fund modality to attract non-core resources for distinct investment or investment-cum-

capacity-building products for LDCs. Distinct products would mirror UNDP/UNCDF partnerships and would be in line with specific service lines in the UNDP multi-year funding framework (MYFF), such as: (a) the UNCDF/Capacity 2015 partnership for strengthening capacities at the local (governance) level for localizing the MDGs; (b) the partnership between UNCDF and the UNDP regional bureaux in the sector development approach to build inclusive financial sectors in Africa and other regions; and (c) the partnership between UNCDF and TICAD for strengthening local governance capacities and localizing the MDGs in LDCs in the Pacific region.

93. Some key financial issues would need to be resolved for any of the sub-options to work smoothly, including:

(a) To facilitate non-core funding for specific UNDP/UNCDF joint programmes at the country level, the incentive system for resource mobilization would be adjusted to ensure that non-core resource mobilization for UNCDF benefits both the mobilizing country office and the co-sponsor of the joint programme. Contrary to what is currently the standard, the UNDP scorecard would recognize resources mobilized for UNCDF as if they were UNDP resources. In addition, UNCDF would reinvest a fixed percentage of extra-budgetary income made on non-core income in country offices, including for the financing of UNCDF professional staff at the country office level.

(b) Cost-recovery mechanisms for technical services provided by UNCDF to UNDP would be adjusted to ensure a level playing field, either by reducing the large subsidy element for UNDP technical expertise, currently paid out of global and regional programmes, or by financing a similar subsidy element for UNCDF technical expertise, when used by UNDP, out of global or regional programme budgets.

Organizational structure, staffing and administrative support arrangements

94. The organizational structure and lines of authority are based on the following principles:

(a) UNCDF would be administered by UNDP, with the UNDP Administrator as Managing Director of UNCDF. UNCDF would report to the UNDP/UNFPA Executive Board.

(b) UNCDF would have a small base structure at the headquarters level and would be highly decentralized to ensure a country-driven approach, favouring co-location and programmatic collaboration with other United Nations organizations, while being located within UNDP country offices and UNDP regional centres.

(c) Where possible, UNCDF would ensure consolidation with UNDP with respect to its organizational support services so as to enhance efficiency and effectiveness.

(d) UNCDF would have an integrated programming framework with UNDP, using the MYFF as its framework for directing investments to specific service lines. At the global, regional and country level, UNCDF would have joint programmes with UNDP, and where possible with other development agencies and United Nations organizations.

Opportunities

95. This option presents considerable opportunities for UNCDF, including opportunities to:

(a) Use the International Year of Microcredit and UNDP's support to significantly upscale marketing and resource mobilization;

(b) Capitalize on the distinct UNCDF investment mandate to mobilize increased levels of resources for investment in LDCs, in run-up and follow-up to the 2005 Millennium event;

(c) Replicate and scale up successful UNCDF products, such as the LDP and the sector approach for building inclusive financial sectors, to other LDCs and, on a cost-recovery basis, to non-LDCs;

(d) Build a strong partnership between UNCDF and Capacity 2015 for the 2005-2015 period, combining capacity-building and investment interventions towards achieving the MDGs at the local level; and

(e) Generate successful downstream interventions with strong policy linkages that conform the interest of UNDP country offices in having a presence on the ground.

Risks

96. The risks associated with this option are:

(a) Prolonged lack of clarity about the future business model and sources for the funding of UNCDF (the administrative and core programme budgets of UNCDF would affect core and non-core resource mobilization opportunities); and

(b) Prolonged lack of clarity about the future business model of UNCDF would affect staff morale and stability.

Factors for success

97. The factors determining the success of this option are:

(a) UNCDF would require a minimum of $22 million per annum in core funding support (base structure plus programme resources) in predictable multi-year funding agreements;

(b) The development of a resource mobilization strategy that effectively brands and markets UNCDF as a multilateral organization specialized in investing in LDCs;

(c) The incentive system for UNDP country offices needs to be adjusted so that they are credited for cost-sharing and trust funds that donors choose to programme through UNCDF for their countries;

(d) An even stronger partnership with UNDP, especially in the areas of advocacy and resource mobilization, integrated into strategic plans and clearly communicated to all UNDP staff.

Option 4. UNCDF microfinance programmes and activities migrated to UNDP

98. In its decision 2004/37, the Executive Board requested the Administrator "to elaborate on the option of integrating UNCDF microfinance activities in UNDP, including possible organizational and funding arrangements and an assessment of the opportunities and risks involved, taking into account the different elements outlined in Executive Board decision 2004/13, and views expressed in the Executive Board, to be presented to the Executive Board at its first regular session in January 2005".

99. This option is similar to option 1, with the exception that the geographical focus is not limited to LDCs, the microfinance programmes and activities being integrated into UNDP instead of implemented by an independent UNCDF.

Situation Analysis

100. The analysis of the role of microfinance in poverty reduction has been discussed in detail in option 1 above. The consensus conclusion is that, in order to achieve its full potential of reaching a large number of poor people, microfinance should become an integral part of the financial sector, leveraging private sector resources.[17]

101. UNDP is the first of the organizations involved in the microfinance peer review to commit to a full portfolio review. The preliminary findings from the external review of the UNDP microfinance portfolio conducted by CGAP[18] found that UNDP has two portfolios in striking contrast to each other. Two-thirds of the projects where UNCDF was involved in the design and ongoing technical support were strong, while none of the projects UNDP carried out on its own were scored as strong. This analysis provides UNDP with a potential roadmap to strengthen its performance dramatically by eliminating bad practices and building on demonstrated strengths, leveraging the UNCDF technical capacity in order to do so.

102. This option builds on the existing collaborative arrangements between UNDP and UNCDF in the area of microfinance, which culminated in the creation of the Special Unit of Microfinance (SUM) in 1997. In 1999, when all microfinance expertise in the UNDP group was consolidated into UNCDF, this unit was located in UNCDF; it was renamed UNCDF-Microfinance early in 2004.

Vision, goals and strate

103. The vision is for the UNDP Microfinance Unit (SUM) to become a centre of excellence in building inclusive financial sectors for the United Nations, mainstreaming best practices into UNDP microfinance programming.

104. The overarching goal of UNDP/SUM would be to contribute to the MDGs, with a particular focus on reducing poverty by increasing sustainable access to financial services for poor and low-income customers, especially women, in developing countries.

[17] Key principles of microfinance. CGAP. Key principles 3 and 5.
[18] Preliminary findings, CGAP external review of the UNDP microfinance portfolio.

105. The strategy of UNDP/SUM would be to focus on supporting the development of start-up and emerging microfinance sectors[19]. UNDP/SUM would work in partnership with UNDP country offices, regional bureaux, other donors, and investors wishing to join in building inclusive financial sectors. UNDP/SUM would operate globally as a policy and technical advisor to UNDP on microfinance and would advocate the application of generally accepted standards of sound principles and practices of microfinance throughout the UNDP group. UNDP/SUM would focus the majority of its technical resources on future programming rather than try to transform current under-performers. The technical advisory services of UNDP/SUM would be available to UNDP country offices wishing to redesign their ongoing microfinance programmes.

106. UNDP/SUM would focus its investments on addressing the key constraints that exclude the vast majority of people to access to financial services by:

(a) *Building enabling environments*. To reach its full potential and have a lasting impact, microfinance should become an integral part of the formal financial system. UNDP/SUM, in collaboration with UNDP country offices, would support countries to formulate and implement national policies and actions plans to address the constraints that hamper the development of the microfinance sector.

(b) *Building sustainable microfinance institutions*. UNDP/SUM and UNDP country offices would invest in building the institutional and human capacity of financial institutions providing microfinance to become fully sustainable and attract funding from semi-commercial and commercial sources to expand in scale and scope.

107. To support this strategy, UNDP/SUM would develop strategic partnerships, including public-private partnerships with private sector institutions, to address constraints that exclude people from participating in the financial sector. UNDP/SUM would work closely with donors, semi-commercial and commercial funders to increase capital flows to developing countries. To strengthen this strategy, UNDP/SUM, based on demand, would locate the majority of its technical expertise in the regions.

Products and services

108. UNDP/SUM, and especially its regional technical expertise, would focus on the products and services outlined in option 1.

Niche and comparative advantage

109. Integrated into UNDP, the comparative advantages of UNDP/SUM within the industry are similar to those highlighted in option 1.

Institutional status, governance and management

110. A key reason to locate SUM in UNCDF was the unique mandate of UNCDF within the United Nations system to provide capital investments and loans. Under this option, were the unit to move back to UNDP it would be important that it carry this mandate with it. The integrated unit would be under UNDP governance arrangements and the Director of UNDP/SUM would

[19] See www.uncdf.org/english/microfinance/sectorDev/index.php for a description of stages in sector development.

report to the Directorate of BDP. The UNDP component of the SUM was previously based in BDP, and could, under the reintegration option, be returned to BDP. This fits with the SUM policy, product development and knowledge-sharing functions.

Funding requirements and arrangements

111. The preliminary findings from the CGAP portfolio review notes that the present microfinance portfolio of UNDP contains many projects where the level of funding is too low to make a difference. This suggests that UNDP might create a substantial central fund that would be available to selected country offices having particularly promising opportunities for microfinance programmes. Country offices would contribute their own funding from TRAC resources, with SUM technical support in design and implementation. This would encourage country offices to make better use of SUM technical input.

Table 4. UNDP microfinance financial projection (in millions of dollars)

Income and expenditure							
	2004	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Income							
Core/non-core funding	6.7	14.1	11.6	11.8	12.0	12.2	12.3
UNDP regional programmes/ SURFs	1.5	5.0	5.1	5.1	5.1	5.2	5.2
UNDP country programmes	1.5	5.0	5.1	5.1	5.1	5.2	5.2
Technical Advisory Services	0.08	0.3	0.4	0.4	0.4	0.5	0.5
Exec./impl. agency fees	0.1	0.3	0.2	0.2	0.2	0.2	0.2
Interest on loans	0.03	0.3	0.6	0.9	1.1	1.4	1.7
Total income	9.9	25.0	23.0	23.5	23.9	24.7	25.1
Expenditure							
Salaries technical staff	1.5	1.6	0.9	1.0	1.1	1.2	1.3
Salaries operations/mgt.	1.3	1.4	0.2	0.2	0.2	0.3	0.3
General operating expenditure	1.0	1.0	0.4	0.4	0.4	0.4	0.5
Sub-total head office	3.7	4.0	1.5	1.6	1.7	1.9	2.0
Regional and country programmes							
Africa	5.0	6.7	6.8	6.8	6.9	6.9	6.9
Asia and the Pacific	-	3.4	3.4	3.4	3.4	3.5	3.4
Arab States	0.4	3.4	3.4	3.4	3.4	3.5	3.4
Latin America	0.4	3.4	3.4	3.4	3.5	3.5	3.4
Europe and the CIS	0.4	3.4	3.4	3.4	3.5	3.5	3.4
Sub-total programmes	6.0	20.1	20.3	20.4	20.6	20.7	20.6
Total expenditure regional and country prog. and headquarters	9.8	24.1	21.8	22.0	22.3	22.5	22.7
Pilot programmes	0.2	0.8	1.2	1.5	1.8	2.1	2.4

Total expenditure	9.9	24.9	23.0	23.5	24.1	24.7	25.0

112. The current biennial budget of UNCDF covers headquarters expenses up to the end of 2005. With integration, starting in 2006, UNDP would provide funding from its biennial budget for the core staff of UNDP/SUM and cover headquarters-related expenses.

113. To be successful, the total amount of yearly core and non-core funding required for programme activities needs to average at least $12 million per annum in multi-year funding commitments from donors. UNDP/SUM would establish trust-fund mechanisms for donors to earmark funds for LDCs, non-LDCs, or regional programmes. Central funding would leverage funding from donors, development banks and the private sector. Through its vast network of donors and commercial investment funds, UNDP/SUM would mobilize additional resources to support UNDP and UNDP/SUM joint country programmes. UNCDF estimates that a total of more than $100 million of additional capital would be mobilized in the ongoing regional programme for Africa in support of the objectives of this programme.

114. Global Cooperation Framework (GCF) funds of $300,000 per annum would contribute to the costs of developing UNDP policy and flagship products and services for UNDP country offices, and UNDP global advocacy, and knowledge sharing. Based on demand and available funding, other regional programmes would be funded by UNDP regional funds, UNDP country programmes, UNDP/SUM, and donor- or host-country government cost sharing.

115. Under this option, the current assets and liabilities UNCDF in microfinance would be transferred to UNDP. Current outstanding and future loan repayments would go into the UNDP/SUM central fund.

Organizational structure, staffing and administrative support arrangements

116. UNDP/SUM would retain a small team at the head office consisting of a director, a deputy director, a training/research/knowledge management manager, a finance officer/fund manager, and support staff.

117. Based on demand, teams would be established at regional centres, consisting of regional managers, technical managers and support. The size of the team would be dependent upon the size of the regional programme. Costs would be covered by regional programmes, UNDP/SUM and UNDP, and from cost-recovery of services to UNDP country offices.

Opportunities and risks

118. This option entails similar opportunities and risks as those mentioned for option 1.

Factors for success

119. UNDP/SUM would require a minimum of $12 million, on average, per annum, in grant fund support from donors in multi-year funding agreements.

120. The incentive system for UNDP country offices would need to be adjusted so that resources invested by UNDP/SUM are credited on the country office scorecard. Similarly, UNDP country offices would need to be credited

for cost sharing that donors might choose to programme through UNDP/SUM for their countries.

121. Institutional arrangements would need to guarantee that decisions on UNDP/SUM investments in building sustainable microfinance institutions could be taken based on technical merit.

Legal implications

122. Since UNCDF is a creation and a subsidiary organ of the General Assembly, it is ultimately for the General Assembly, presumably upon recommendation of the Executive Board and ECOSOC, to decide on changes in its mandate. Since the option of integration of microfinance into UNDP is accompanied by the creation of the CLD (see option 2 above), the current UNCDF mandate would switch to UNDP, and UNCDF would cease to exist. The implications are that assets and liabilities (human, financial and property) would go to UNDP, while presentation of activities and financial reporting would be integrated into UNDP reporting. Since microfinance activities include the provision of soft loans to microfinance institutions, it would also mean that the UNDP mandate would need to be adjusted to enable it to make loans.

V. Conclusion

123. This document has presented four options developed and elaborated in response to Executive Board decision 2004/37. An evaluative framework setting the key guiding principles and strategic criteria formed the basis upon which the proposed options were developed. It is hoped that the application of this framework will facilitate decision making by the Board on the future of, and positioning for, a revitalized UNCDF. In this regard, the Administrator would like to engage the Executive Board in a consultation process to seek its guidance with respect to the proposed options.

124. Pursuant to the guidance of the Executive Board, it is envisaged that UNCDF and UNDP will be able to proceed with further consultations and elaborate on the option preferred by the Executive Board.

Annex 1. Matrix for comparison of options

Options Implications	Option 1: Independent UNCDF focusing on microfinance	Option 2: Migration local development to UNDP	Option 3: Independent UNCDF	Option 4: Migration microfinance to UNDP
Vision and expected results	To become a recognized leader in building inclusive financial sectors in the LDCs. By 2010: Inclusive financial sector development achieved in 20 LDCs; 25 fully self-sufficient MFIs; 20 MFIs with national coverage; 5 million client base achieved	As a risk-taking, piloting entity within UNDP, support the LDC governments in the development of effective, decentralized public investments for infrastructure and service delivery to the poor. Results by 2009: Effective, decentralized local infrastructure and service delivery systems piloted in 40 LDCs.	To be a focused, innovative, risk-taking United Nations fund making and-driven, small-scale investments in LDCs towards the realization of the objectives of the Brussels Plan of Action for LDCs and the achievement of the MDGs at the local le: el Results are a combination of the results for options 1 and 2	To become a centre of excellence in building inclusive financial sectors for the UN and to mainstream best practices into UNDP microfinance programming. Results would be in accordance with the relevant UNDP MYFF service lines.
Governance/ management	No change to the current governance of UNCDF, i.e., Executive Board > UNDP Administrator > Executive Secretary	Comes under UNDP governance, i.e., Executive Board > UNDP Administrator > BDP Director	No change to current governance of UNCDF, i.e., Executive Board > UNDP Administrator > Executive Secretary	Comes under UNDP Governance, i.e., Executive Board > UNDP Administrator > BDP Director
Legal	There are no legal implications unless the option of assessed contributions is to be pursued.	The mandate for capital assistance would have to be transferred to UNDP to allow continued capital investments for Local Development Programmes.	There are no legal implications unless the option of assessed contributions is pursued.	The mandate fo: capital assistance would have to be transferred to UNDP to allow continued capital investments and loans for microfinance programmes. General Assembly decision would be required for the termination of UNCDF as a United Nations entity should both LD and MF activities be integrated into UNDP.
Core staffing at HQ and staffing regional centres	Total: 16-20 12 at headquarters 4-8 at regional centres (to be determined by size of programme)	Total: 22 12 at headquarters (UNDP) 10 at regional centres	Total: 38-42 24 at headquarters 14-18 at regional centres	Total: 10 -14 6 headquarters (UNDP) 4-8 at regional centres (to be determined by size of programme)
Avg. annual expenditures total, admin. + programme for 2006-2010 period	Total annual exp: $14.5 million Admin: $2.6 million Programme: $1' .9 million (*NB* Excludes $10 million UNDP programme exp. and leveraged parallel donor/private sector exp.)	Total annual exp: $54.8 million Admin: $2.7 million Programme: $52.1 million	Total annual exp.: $ 69.3 million Admin: $ 5.3 million Programme: $64 million	Annual average: $13.9 million Admin: $1.7 million Programme: $12.2 million (*NB* Excludes $10 mil. UNDP reg./ country programmes and leveraged parallel donor/private sector exp.)

Annex 2 - Overview of Options and (sub) Options for UNCDF Future Business Model